Office of Chief Counsel
Internal Revenue Service
memorandum
CC:[redacted]:TL-N-6908-99
[redacted]

date:

to: Chief, Examination Division, [redacted] District
Attention: Revenue Agent [redacted]

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted]
Debt and interest dischargeability

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ISSUES:

1. Whether the taxpayer, an accrual basis taxpayer, can deduct interest as it accrues although the interest is ultimately not paid?

2. Whether the taxpayer must recognize income on the discharge of indebtedness for the debt principal incurred when it purchased its own stock from its former shareholders?

(a) Whether the purchase price reduction exception under I.R.C. § 108(e)(5) applies to the principal debt?

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3. Whether the taxpayer must recognize income on the discharge of indebtedness on the accrued interest incurred when it purchased its own stock from its former shareholders?

(a) Whether the purchase price reduction exception under I.R.C. § 108(e)(5) applies to the accrued interest?

(b) Whether the taxpayer can defer income recognition on the discharge of indebtedness on the accrued interest incurred when it purchased its own stock from its former shareholders by reducing the basis of the asset under I.R.C. §§ 108 and 1017?

CONCLUSIONS:

1. The taxpayer, an accrual basis taxpayer, can deduct interest as it accrues although the interest is ultimately not paid if bona fide debt was involved.

2. The taxpayer does not recognize income on the discharge of indebtedness for the debt principal incurred when it purchased its own stock from its former shareholders.

(a) The purchase price reduction exception under I.R.C. § 108(e)(5) applies to the principal debt.

3. The taxpayer must recognize income on the discharge of indebtedness on the accrued interest incurred when it purchased its own stock from its former shareholders.

(a) The purchase price reduction exception under I.R.C. § 108(e)(5) does not apply to the accrued interest.

(b) The taxpayer cannot defer income recognition on the discharge of indebtedness on the accrued interest incurred when it purchased its own stock from its former shareholders by reducing the basis of the asset under I.R.C. §§ 108 and 1017.

FACTS AND DISCUSSION:[1]

[redacted] is under examination by the Internal Revenue Service for the fiscal year ending [redacted]

[1] The facts which form the basis for this opinion were derived from the [redacted] memorandum to the file which was provided by [redacted] to the Internal Revenue Service. The veracity of the facts may bear on the determinations expressed herein.

[redacted]. On [redacted], the beginning of the fiscal year, [redacted] had debt on its books of $[redacted] and accrued interest of $[redacted], both of which were related to the purchase of its stock from former shareholders (creditors). The original principal balance was $[redacted] on [redacted], which was represented by a note bearing [redacted]% interest. [redacted] and the creditors agreed on [redacted] to a reduction of principal and interest totaling $[redacted], representing $[redacted] in principal and interest of $[redacted] which was accrued as of that date in exchange for an immediate payment of $[redacted].[2] The remaining noncanceled debt and interest on that amount accrued after [redacted] was paid between [redacted] and [redacted].

Accrual interest deduction:

The taxpayer is an accrual basis taxpayer. The taxpayer is correct for the reasons stated in the [redacted] memorandum to the file that an accrual basis taxpayer accounts for liabilities when the expense is accrued whether or not it is paid. Although the taxpayer is correct from an accrual basis accounting standpoint that the inability to pay the interest will not prevent accrual and deduction, a more fundamental determination is whether the notes represented debt or equity.

Although the inability to make interest payments has little bearing with the propriety of accruing interest, expectation of repayment is a significant factor in judging the validity of the debt. This presumably is the reason why the taxpayer included facts of the alleged declining principal balance and estimate of the time period in which interest accrued but was not paid. See and compare Covey v. Commissioner, T.C. Memo. 1969-273 and Medieval Attractions, N.V. v. Commissioner, T.C. Memo. 1996-455 and Tampa & Gulf Coast Railroad Co. v. Commissioner, 56 T.C. 1393 (1971) (debt is an advance that the debtor is legally obligated

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[2] Under the facts as we understand them, the [redacted] principal balance was reduced by $[redacted] leaving a balance of $[redacted], which was paid between [redacted] and [redacted] together with interest on that amount. Since it is not clear why creditors of a solvent debtor would agree to a debt reduction, you may want to consider determining the reason for the debt reduction. Moreover, there is no apparent rationale for the amount of the debt reduction (principal and interest reduction of $[redacted] out of total amount owed of $[redacted] or [redacted]% or principal reduction alone of $[redacted] out of $[redacted] owed) and you may want to determine the basis for the amount of the reduction.

to repay in all events while equity is money put to the risk of the venture). If the amounts owed to the creditors in substance represent equity, then the interest deductions would not be allowable as the payments may constitute dividends or return of capital depending on earnings & profits.

To the extent that you deem it appropriate to initially pursue this matter, we suggest that you determine the relationship between the creditors and the taxpayer and the extent to which they remained associated with the taxpayer after the stock sale. Generally, a taxpayer's debt argument is weakened where the dealings reflect little concern over the repayment of debt. The ultimate test is whether an independent lender would have placed funds at the risk of the business in the situation presented or have been as indulgent in not enforcing its rights as a creditor. Id. The debt-equity issues generally arise in the context of a shareholder-creditor. Id.[3] You may also want to examine the history of the relationship between them, including inter alia, the form and substance of the [redacted] sale, the stock sale terms and reason for the [redacted] stock sale, the history of repayment, the dividend history and the reason for the [redacted] compromise in order to determine whether bona fide debt existed. We can assist you in pursuing and/or analyzing facts to the extent that you determine that further scrutiny is warranted.

Forgiveness of indebtedness - debt principal:

The taxpayer alleges that the cancellation of the indebtedness for the principal balance is excepted from taxable income as a reduction of purchase price under I.R.C. § 108(e)(5). The taxpayer's position has substantial merit. The I.R.C. § 108(e)(5) purchase price reduction was added by the Bankruptcy Tax Act of 1980. Sutphin v. United States, 61 AFTR2d ¶ 88-990 (Ct. Fed. Claims 1988). It codified the common law and provided for a basis reduction instead of immediate gain. Preslar v. Commissioner, 167 F.3d 1323 (10th Cir. 1999). It was enacted to create uniformity and eliminate disagreements between taxpayers and the Internal Revenue Service as to whether cancellation of indebtedness were true price reductions. Id; Brantley v. Commissioner, T.C. Memo. 1995-564.

In order to facilitate the objective of eliminating disagreements, the application of I.R.C. § 108(e)(5) is for the most part a mechanical test, the requirements of which are stated in the taxpayer's October 11, 1999 memorandum. To apply, there

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[3] In this regard, the taxpayer refers to the creditors as **former** and not current shareholders.

must be a direct agreement between the buyer and seller. Preslar v. Commissioner, supra; DiLaura v. Commissioner, T.C. Memo. 1987-291; and Rev. Rul. 92-99, 1992-46 I.R.B. 5.[4]

Based on the facts contained in the [redacted] memorandum to the file, we believe that the debt reduction qualifies under I.R.C. § 108(e)(5) as a purchase price reduction.[5] Id. The three statutory requirements under I.R.C. § 108(e)(5) have been satisfied as well as the three non-statutory requirements discussed in footnote 4 (presuming that the treasury stock was not sold and the debt repayments were made to the same shareholders who sold the stock). Except for the uncollectibility of the debt for statute purposes, the reason that the debt was canceled is no longer relevant in light of I.R.C. § 108(e)(5).[6] Therefore, we believe that I.R.C. § 108(e)(5) applies as an exception to the recognition of income for cancellation of indebtedness.[7]

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[4] In his dissent in Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F.2d 110 (3rd Cir. 1990), Judge Ruwe, relying on the legislative history, posited that the following limitations to application of I.R.C. § 108(e)(5) existed: (1) the reduction could not be due to the expiration of the statute of limitations; (2) the debt could not have been transferred to a 3rd party; and (3) the purchased property could not have been transferred to a 3rd party. You may want to determine the reason for the debt cancellation in [redacted], especially in light of the taxpayer's statement, albeit in support of the interest accrual issue, that the taxpayer was solvent and the creditors could have collected the entire amount had they pursued it.

[5] The I.R.C. § 108(e)(5) provisions are not elective. Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F.2d 110 (3rd Cir. 1990).

[6] While there could be an argument that the stock was not the type of property that I.R.C. § 108(e)(5) was meant to apply to, the chance of success on this issue is speculative. In Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F.2d 110 (3rd Cir. 1990), the majority of the Tax Court determined that the type of property involved, that is, the opportunity to gamble, which was not the type of property that I.R.C. § 108(e)(5) was meant to apply to. In his dissent, Judge Ruwe criticized the majority's determination that I.R.C. § 108(e)(5) property included tangible property and some but not all types of intangibles.

[7] As discussed below, a corporation which purchases its own stock no longer has a basis in the stock. Since the effect of

Forgiveness of indebtedness - interest:

The taxpayer further argues that accrued and deducted but unpaid interest which was canceled is also a non-taxable reduction of the purchase price. We do not agree.

The taxpayer cites Rev. Rul. 67-200, 1967-1 C.B. 15 in support of its position. Rev. Rul. 67-200 however was rendered obsolete in 1986 when the Tax Reform Act repealed the elective exception to reduce basis for the discharge of qualified business indebtedness. In any event, it applied only to depreciable property, of which the taxpayer's own corporate stock held as treasury stock is not.[8] See also Rev. Rul. 70-406, 1970-2 C.B. 16, which clarified Rev. Rul. 67-200. Even if Rev. Rul. 67-200 applied, it would afford no relief to the taxpayer. Under Rev. Rul. 67-200, the taxpayer would be required to reduce his basis in the asset for the amount of debt forgiven. A corporation which purchases its own stock as treasury stock has no basis. Rev. Rul. 74-503; Webb v. Commissioner, 67 T.C. 293, fn 5 (1976). Therefore, there would be no basis to reduce and the taxpayer would be subject to an income adjustment even if Rev. Rul. 67-200 applied.

The taxpayer argues that interest is included within the scope of the purchase price reduction under I.R.C. § 108(e)(5), in part through the definition of indebtedness. I.R.C. § 108(d)(1) defines "indebtedness of the taxpayer" as any indebtedness for which the taxpayer is liable. Indebtedness in I.R.C. § 108(d)(1) is a term of art as reflected by the quotation marks that precede and follow the term. Indebtedness of the taxpayer is found in I.R.C. § 108(a)(1), the general cancellation of indebtedness provision. The terminology used in I.R.C. § 108(e)(5) however refers to "the debt of a purchaser of property." I.R.C. § 108(e)(5) does not define debt. That it was used in a specific and narrower provision than that to which the I.R.C. § 108(d)(1) indebtedness applies belies any credence that it lends any support to the taxpayer's argument.

I.R.C. § 108(e)(5) is to defer gain by reducing basis, it could be argued that corporate stock purchased by the issuing corporation is not the type of intangible that I.R.C. § 108(e)(5) was intended to apply to since there are no tax consequences from the purchase or sale of its own stock. We will seek the National Office's view of this in our request for their post-review.

[8] A corporation's treasury stock is not considered an asset but an offset to the shareholder's equity on the liability side of the balance sheet. Commissioner v. Fink, 483 U.S. 89, fn. 9, 11 (1987).

Rather, we believe that the statute itself supports the determination that interest forgiveness is not included in a purchase price reduction. I.R.C. § 108(e)(5) is entitled "PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION." The interest was not a part of the purchase money debt incurred to purchase the property.[9] As noted earlier, the purpose of I.R.C. § 108(e)(5) was to reduce disagreements over the factual issue as to whether the cancellation was a true reduction of the purchase price, that is, did the taxpayer get everything bargained for at the time of the transaction. Cancellation of the accrued interest does not factor into this basis unless interest was proportionately decreased with the principal which is not what occurred here.[10] The effect is to

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[9] Interest is the cost of financing. Fort Howard Corporation v. Commissioner, 103 T.C. 345 (1994). Therefore, while it is conceptually a part of the price ultimately paid for property, it is not truly a part of the purchase price paid for the property.

[10] There could have been collusion between the creditors and the taxpayer in the allocation of the principal and interest that was canceled. All of the accrued interest was canceled but only a small portion of the principal. Because of this allocation, the taxpayer deducted the interest although the creditors never took the interest into income since it was not paid. You may want to consider whether the Internal Revenue Service should raise as an alternative argument a proportionate allocation of the canceled principal and interest such that interest income is reported by the creditors. The creditors' [redacted] income tax returns would have to be examined to accomplish this. One possible methodology is to allocate the total [redacted]% reduction of principal and interest proportionately to the total amount that was canceled. The following shows the manner in which the canceled debt was allocated and could be allocated:

	Principal	**Interest**	**Total**
Beg. Balance	$[redacted]	$ [redacted]	$[redacted]
Accruals		$ [redacted]	$[redacted]
Canceled per Taxpayer	$ [redacted]	$ [redacted]	$ [redacted] or [redacted]%
Canceled per [redacted]% reallocation	$ [redacted]	$ [redacted]	

defer gain by reducing basis to the amount ultimately paid.[11]

That the purchase price reduction rules apply only to the principal and not interest is consistent with the Internal Revenue Service's long-standing policy. However, in Putoma Corporation v. Commissioner, 66 T.C. 652 (1976), aff'd, 601 F.2d 734 (9th Cir. 1979), a case involving the cancellation of previously accrued and deducted but unpaid interest, the courts held that the non-taxable gift (I.R.C. § 102) and capital contribution (I.R.C. § 118) provisions were exceptions to the tax-benefit rule. The courts reasoned that the tax benefit rule was subsumed within the cancellation of indebtedness rules and that the judicially created tax benefit rule could not override specific statutes which treated the transactions as non-taxable. The courts took the position that the prior deductibility of the interest was irrelevant to its conclusion, a determination that the Internal Revenue Service has continued to disagree with. It is not believed that Putoma Corporation v. Commissioner, supra, will adversely affect the Internal Revenue Service's determination in this case since the purchase price reduction rules are a specific type of cancellation of indebtedness relief.

Assuming that the legal position advocated herein is sustained, a reallocation would be collectively be approximately a wash (depending on the tax rate differences) since the although the individual creditor-taxpayers would be required to report the interest income, [redacted] would be able to defer gain recognition to the extent that forgiven interest is reallocated to principal as a purchase price reduction. The biggest impact from the alternative argument would be if the United States loses the interest forgiveness issue as [redacted] would be able to defer gain on both the forgiven principal and interest and therefore, allocation would be irrelevant to them. A reallocation to interest in that instance would correct a portion of the mismatching by recovering some income from the creditors.

[11] In addition, interest is deductible and in fact was deducted instead of being capitalized and added to basis. If it was included as a part of basis as the purchase price was, then a symmetrical correlative adjustment for interest forgiveness would be basis reduction. That interest is deductible and does not have to be capitalized as part of the basis supports the argument that it is not included in the purchase price reduction exception which seeks to reduce the purchase price and therefore the basis to the amount ultimately paid.

Please contact the undersigned at [redacted] if you have any questions. Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you. We are seeking post-review by the National Office due to the uniqueness of the issue. We should hear back from them shortly. In the interim, you should consider the extent that factual development is necessary and/or draft a proposed position in order to seek the taxpayer's position.

[redacted]

By: [redacted]

Senior Attorney